Supreme Court, U. S.
FILED
JUN 28 1973
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 73-26

ESTATE OF JOSEPH MIELE, Deceased, NORMAN E. ALBERS, NICHOLAS JOYA and HORACE D. MARUCCI, Executors, ANTHONY P. MIELE and MARIA E. MIELE, V. JAMES SPINIELLO and GLORIA SPINIELLO, LUKE C. SPINIELLO and GRACE SPINIELLO, and LaFERA CONTRACTING COMPANY,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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INDEX TO PETITION

	PAGE
PRELIMINARY STATEMENT	1
OPINIONS BELOW	2
JURISDICTION	2
QUESTIONS PRESENTED	3
STATUTES AND REGULATIONS INVOLVED	3
STATEMENT OF THE CASE	3
REASONS FOR GRANTING THE WRIT:	
1. United States v. Davis, 397 U. S. 301 (1970), regarded by the courts below to be controlling herein, should be reconsidered	6
2. This case presents an important policy question, not raised or considered in United States v. Davis, supra, affecting the just administration of the revenue laws	9
CONCLUSION	12
APPENDIX:	
A—Official Findings of Fact and Opinion of the United States Tax Court	1a
B—T. C. Memo. 1971-161	16a
C—Judgment Order	18a
D—Order of the United States Tax Court	22a

Cases Cited

Boys Markets, Inc. v. Retail Clerks Union, 398 U. S. 235 (1970) 9

PAGE

Davis v. United States, 408 F. 2d 1139 (6th Cir. 1969) 7, 8, 11

Earle v. Woodlaw, 245 F. 2d 119 (9th Cir. 1957) 7

Flanagan v. Helvering, 116 F. 2d 937 (D. C. Cir. 1940) 7

Helvering v. Hallock, 309 U. S. 106 (1940) 9

Heman v. Comm'r, 283 F. 2d 227 (8th Cir. 1960) 7

Jones v. Griffin, 216 F. 2d 885 (10th Cir. 1954) 7

Keefe v. Cote, 213 F. 2d 651 (1st Cir. 1954) 7

Mastro Plastics Corp. v. NLRB, 350 U. S. 270 (1956) 8

Smith v. United States, 130 F. Supp. 586 (Ct. Cl. 1955) 7

Thomas Kerr, 38 T. C. 723 (1962), aff'd 326 F. 2d 225 (9th Cir. 1964) 7

United States v. Davis, 397 U. S. 301 (1970) 3, 5-7, 9, 11

United States v. Fewell, 255 F. 2d 496 (5th Cir. 1958) 7

Statutes Cited

Internal Revenue Code of 1954:

Sec. 302 3

Sec. 302(a) 6

Sec. 302(b)(1) 3, 6-8

Merchant Marine Act of 1936, as amended:

Subchapter XI 3, 10, 11

28 U.S.C.:

Sec. 1254(1) 2

PAGE

46 U.S.C.:

Sec. 1271 ..... 3, 10

Sec. 1278 10

Rule Cited

Rule 23 (Par. 1) 1

Other Authorities Cited

Bacon, "Share Redemptions", 26 Tax. L. R. (1971):

283, 289 8

Roberts, et al., "Complexity and Income Tax", 27 Tax L. R. (1972):

325, 358-359 7

Regulations Cited

Treasury Regulations:

Sec. 1.302-2 ..... 3, 8

Sec. 298.4(n), published in the Federal Register (23 F. R. 384), January 22, 1958, as General Order 29, Revised 3, 9, 11

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No.

ESTATE OF JOSEPH MIELE, Deceased, NORMAN E. ALBERS, NICHOLAS JOYA and HORACE D. MARUCCI, Executors, ANTHONY P. MIELE and MARIA E. MIELE, V. JAMES SPINIELLO and GLORIA SPINIELLO, LUKE C. SPINIELLO and GRACE SPINIELLO, and LAFERA CONTRACTING COMPANY,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petitioners pray that a writ of certiorari issue to review the respective judgments of the United States Court of Appeals for the Third Circuit, rendered below (Nos. 72-1031, 72-1032, 72-1254, 72-1255 and 72-1368).

Preliminary Statement

This is a single petition filed under the authority of Rule 23 (Paragraph 1.) to seek review of five related cases involving identical facts and questions of law.

One of the parties below, Joseph Miele, died following remand of his case to the Tax Court by the Court of Appeals. By order of the Tax Court dated May 8, 1973 (Appendix D, p. 22a), the Estate of Joseph Miele has been substituted as a party.

Opinions Below

The findings of fact and opinion filed by the Tax Court in the *Miele* and *Spiniello* cases are reported at 56 T.C. 556 (Appendix A, pp. 1a-15a).

The memorandum findings of fact and opinion of the Tax Court in the *La Fera* case, not officially reported, has been designated "T.C. Memo. 1971-161" (Appendix B, *infra*, pp. 16a-17a).

No opinion was filed in the Court of Appeals, which, however, issued Judgment Orders in all five related cases (Appendix C, *infra*, pp. 18a-21a), affirming the respective decisions of the Tax Court in respondent's favor.

Jurisdiction

The judgment of the Court of Appeals (in Nos. 72-1031 and 72-1032 below) was entered on January 30, 1973. Appendix C, *infra*, pp. 18a-19a). With respect to such judgment, the time for filing a petition for a writ of certiorari was extended, by order (dated April 17, 1973) of Mr. Justice Brennan, to and including June 29, 1973.

The judgment of the Court of Appeals in (Nos. 72-1254, 72-1255 and 72-1368, below) was entered on April 11, 1973. (Appendix C, *infra*, pp. 20a-21a).

The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

Questions Presented

1. Whether *United States* v. *Davis*, 397 U. S. 301 (1970) is correct in holding that the business purpose of a transaction is irrelevant in determining dividend equivalence under section 302(b)(1) of the Internal Revenue Code?

2. Assuming, *arguendo*, that *United States* v. *Davis*, *supra*, enunciates a correct *general* rule, does not simple justice preclude application of so rigid a rule to a transaction whose form is virtually dictated by regulations of a Federal agency?

Statutes and Regulations Involved

The pertinent provisions of section 302 of the Internal Revenue Code of 1954; of §1.302-2 of the Treasury Regulations promulgated thereunder; of Subchapter XI of the Merchant Marine Act of 1936, as amended, 46 U.S.C. §1271 et seq.; and of Regulations §298.4(n) promulgated thereunder, are set forth under "Reasons for granting the Writ", *infra*.

Statement of the Case

As noted under the heading, "Opinions Below", *supra*, no opinion in these related cases was rendered in the Court of Appeals, which by "Judgment Orders" affirmed the Tax Court's decisions in favor of the government.

For purposes of this petition the briefest outline of the facts, as found by the Tax Court, is sufficient.

A & S Transportation Co. (hereinafter referred to as "A & S") was incorporated under the laws of New Jersey on January 17, 1945. Its original authorized capital consisted of 1,000 shares of common stock having a par value of $100 per share (App. A, pp. 2a-3a).

With insignificant variations, the beneficial interests in 132 issued and outstanding shares of A & S common stock (as described above) have been held at all material times as follows (App. A, p. 3a):

Beneficial Owner	*Number of Shares*
Joseph Miele	22
Anthony P. Miele	22
Luke Spiniello	22
V. James Spiniello	22
La Fera Contracting Co.	44

At all times since its incorporation, A & S has been engaged in the business of moving sludge out to sea by means of one or more sea-going barges (App. A, p. 4a).

For more than a decade following its incorporation in 1945, A & S conducted its business by operating a single barge, the "Dykes". By 1956, exorbitant repair costs made replacement of the "Dykes" a business necessity. Resort was had to the Maritime Commission, empowered (under the Merchant Marine Act of 1936) to encourage the development of a domestic merchant fleet by insuring marine construction loans (App. A, p. 4a).

Pursuant to the requirements of the Maritime Administration, dealing with Federal Ship Mortgage and Loan Insurance, A & S was required to have a prescribed minimum equity capital in order to be eligible for the necessary amount of loan and mortgage insurance (App. A, p. 5a).

In 1959, the stockholders of A & S complied with such requirement by making $150,000 of their personal funds available to A & S. Such capital contributions were made by the taxpayers in direct proportion to their respective

holdings of A & S common stock. In exchange they received certificates denominated, "non-voting, non-dividend paying, non-cumulative preferred stock", which could be redeemed, at par, after five years; and had to be redeemed at par no later than ten years after issuance (App. A, pp. 5a-6a).

A & S obtained an insured ship mortgage loan in the amount of $380,000. acquired a new barge with the proceeds, and operated it successfully thereafter (App. A, p. 7a).

By August 31, 1964, the ship mortgage loan had been paid off in full. Having no further need for the $150,000 paid in by its stockholders, A & S returned their money to them, dollar for dollar, during 1965 and 1966; and the so-called preferred stock was "redeemed" (App. A, pp. 7a-8a).

The Tax Court rejected the taxpayers' alternative contentions (1) that the A & S preferred stock issued in 1959 and redeemed in 1964 and 1965 was in reality debt; and (2) that the rigid rule of *United States* v. *Davis,* 397 U. S. 301 (1970) ought to be avoided herein in view of both factual distinctions and equitable considerations (App. A, pp. 14a and 15a).

The Court of Appeals affirmed on authority of *United States* v. *Davis, supra* (App. C, p. 19a).

REASONS FOR GRANTING THE WRIT

1. *United States* v. *Davis*, 397 U. S. 301 (1970), regarded by the courts below to be controlling herein, should be reconsidered.

(a) *Davis* involves section 302(b)(1) of the Internal Revenue Code of 1954,[1] which, in conjunction with section 302(a),[2] permits a redemption of corporate stock which "is not essentially equivalent to a dividend" to be treated as a return of capital.

Davis, adopting a so-called "strict net effect test", holds that section 302(b)(1) must be applied to redemptions on a strictly objective basis without regard to the business purpose, if any, for the transaction and solely be reference to whether the exchange causes "a meaningful reduction of the shareholder's proportionate interest in the corporation".

Prior to *Davis*, and contrary to its holding, the Tax Court, the Court of Claims, and most Courts of Appeals

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[1] Internal Revenue Code of 1954 (26 U.S.C.).

> Sec. 302. Distributions in Redemption of Stock.
>
> (a) General Rule.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3) or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.
>
> (b) Redemptions Treated as Exchanges.—
>
> (1) Redemptions not equivalent to dividends.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

[2] See f.n. 1, *supra*.

had applied a different rule known as the "flexible net effect test". *Thomas Kerr*, 38 T. C. 723 (1962), aff'd 326 F. 2d 225 (9th Cir. 1964); *Smith* v. *United States*, 130 F. Supp. 586 (Ct. Cl. 1955); *Flanagan* v. *Helvering*, 116 F. 2d 937 (D. C. Cir. 1940); *Keefe* v. *Cote*, 213 F. 2d 651 (1st Cir. 1954); *United States* v. *Fewell*, 255 F. 2d 496 (5th Cir. 1958); *Davis* v. *United States*, 408 F. 2d 1139 (6th Cir. 1969); *Heman* v. *Comm'r*, 283 F. 2d 227 (8th Cir. 1960); *Earle* v. *Woodlaw*, 245 F. 2d 119 (9th Cir. 1957); *Jones* v. *Griffin*, 216 F. 2d 885 (10th Cir. 1954).

The "flexible net effect test", in general, results in a finding of *non*-dividend equivalence under section 302 (b) (1), where the redemption is untainted by any tax avoidance motives and has its roots in legitimate business purposes.

(b) Only six members of this Court, as now constituted, participated in *United States* v. *Davis, supra*. Mr. Justice Marshall wrote the majority opinion with Mr. Justice Stewart and Mr. Justice White joining; whereas Mr. Justice Douglas wrote a dissent with which the Chief Justice and Mr. Justice Brennan concurred. Id. 313.

(c) The majority opinion acknowledges that "the intended scope of §302(b)(1) as revealed by [its] this legislative history is certainly not free from doubt". Id. 311.

(d) *Davis* has been criticized as representing unwarranted judicial legislation. Roberts et al., "Complexity and Income Tax" 27 TAX L. R. 325, 358-359 (1972). Such criticism accords with the observation in Mr. Justice Douglas' dissent, that the majority holding "effectively cancels §302(b)(1) from the Code". *United States* v. *Davis, supra*, 314.

It has been pointed out also that such holding leaves unclear its applicability to redemptions by public com-

panies. Bacon, "Share Redemptions", 26 TAX L. R. 283, 289 (1971).

(e) Here, as in *Davis,* stockholders acting under compulsion of unquestioned business necessity and with no thought of tax avoidance, contributed to the capital of a corporation. Once such necessity had abated, the precise amount of their investment was returned to them, as originally contemplated, without increment or other economic benefit.

The pertinent Treasury Regulation[3] specifies that applicability of section 302(b)(1) depends upon the facts and circumstances of each case. However, the strict net effect test of *Davis* ignores such circumstances as underlying business necessity and absence of tax avoidance motives and treats as ordinary income the mere return of one's own money.

In the face of a legislative history, admittedly "not free from doubt", an interpretation which is not expressly called for by the language of the statute itself ought not produce such harsh and incongruous results. *Mastro Plastics Corp.* v. *NLRB,* 350 U. S. 270, 286 (1956).

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[3] Treasury Regulations on Income Tax (1954 Code):

§1.302-2 Redemptions not taxable as dividends.

(a) The fact that a redemption fails to meet the requirements of paragraph (2), (3) or (4) of section 302(b) shall not be taken into account in determining whether the redemption is not essentially equivalent to a dividend under section 302(b)(1). * * *

(b) The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. * * *

(f) *Stare decisis* does not require "adherence to the latest decision, however recent and questionable, when such adherence involves collision with a prior doctrine more embracing in its scope, intrinsically sounder, and verified by experience." *Helvering* v. *Hallock*, 309 U. S. 106, 199 (1940); *Boys Markets, Inc.* v. *Retail Clerks Union*, 398 U. S. 235, 241 (1970).

2. This case presents an important policy question, not raised or considered in *United States* v. *Davis*, *supra*, affecting the just administration of the revenue laws.

(a) In *United States* v. *Davis, Inc.*, the Reconstruction Finance Corporation and a Nashville, Tennessee bank agreed to make a commercial loan to a newly-formed corporation provided, *inter alia*, that the incorporators provided $25,000 of additional working capital either by loan or purchase of stock.

In the case *sub judice* it was stipulated below that the U. S. Maritime Commission granted a similar choice to the stockholders of A & S. However, regulations promulgated by the Maritime Administration provide persuasive evidence that controlling law, which must override a contrary fact stipulation, if there is any discrepancy between the two, *required* that an additional contribution be made to capital. Regulations, §298.4(n), published in the Federal Register (23 F. R. 384) on January 22, 1958, as General Order 29, Revised, provides as follows:

> (n) Net worth; mortgage and loan. To be eligible for loan and/or mortgage insurance, the applicant shall submit evidence satisfactory to the Secretary showing that at the time of execution of the

contract of insurance he will have net worth (equity capital) composed of outstanding paid-in capital stock or a paid-in surplus and/or earned surplus, but not less than 50 per centum of which shall represent common stock equity, in an amount equal to at least the following:

(1) Complement of the mortgage, e.g. 25 per centum or 12½ per centum, as the case may be, of "actual cost" as determined in accordance with § 298.7(a), or of the loan (if not to be replaced by a mortgage), e.g. 25 per centum of "actual cost" as determined in accordance with §298.7(a).

(2) Plus, in the case of a mortgage, one pro rata portion of the proposed original principal amount of the mortgage, e.g. 1/20th on a twenty-year mortgage or 1/10th on a ten-year mortgage, etc.

(3) Plus, any additional amount determined by the Secretary to be necessary by reason of other activities of the applicant not covered by paragraph (o) of this section.

The authority of grant Federal Ship Mortgage Insurance, and to promulgate the foregoing regulation in connection therewith is set forth in Subchapter XI of the Merchant Marine Act of 1936, as Amended, 46 U.S.C. §1271 et seq.

Section 1278 (46 U.S.C. §1278) provides as follows:

§1278 *Rules & Regulations*

The Secretary of Commerce is authorized and directed to make such rules and regulations as may be deemed necessary or appropriate to carry out the purposes and provisions of this subchapter.

After successfully operating the "Dykes" between 1945 and 1958, A & S required a new barge to stay in business. Without a loan insured by the Maritime Administration pursuant to Chapter XI of the Merchant Marine Act of 1936, as amended, A & S would not have been able to acquire a new barge. And unless the taxpayers had complied, as they did, with the equity capital requirements of Regulations, §298.4(n), A & S could not have qualified for Federal Ship Mortgage Insurance. When in 1965, the ship loan had been paid off, the taxpayers got their money —no more, no less—back again.

(b) Now, the government says, and the courts below, deeming *Davis* to control, have agreed, that although the taxpayers acted in good faith, and in a real sense, under compulsion of Federal law, they must treat the return of their own money as a taxable dividend and pay a tax thereon.

This Court, whose ultimate aim is justice, should not permit such an incongruous result to stand; and specifically should not authorize an interpretation of the tax laws which permits one arm of the government to levy taxes on those who without economic gain to themselves have complied with the statutorily authorized regulations of another arm of the same government.

(c) The foregoing contention was neither presented to, nor considered by the Supreme Court in *United States* v. *Davis, supra.* Perhaps the facts there, and specifically the absence of any mandatory requirement such as that prescribed in Regulations, §298.4(n), *supra,* did not permit the presentation of such an argument. However, a basis for distinguishing this case from *United States* v. *Davis, supra,* as a matter of law, not to mention equity and conscience, is provided here.

CONCLUSION

For the foregoing reasons the petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

Official Findings of Fact and Opinion of the United States Tax Court

(Filed June 21, 1971, and officially reported at 56 T.C. 556)

QUEALY, *Judge*: The respondent determined deficiencies in the Federal income taxes due from the petitioners as follows:

Docket No.	*Year*	*Deficiency*
405-70	1965	$7,679.52
[Joseph Miele]	1966	8,386.20
421-70	1965	7,354.70
[V. James & Gloria Spiniello]	1966	6,054.23
422-70	1965	5,799.74
[Anthony P. & Maria E. Miele]	1966	6,417.35
423-70	1965	5,777.85
[Luke C. & Grace Spiniello]	1966	5,073.45

The issues presented for decision are:

(1) As to all dockets, whether petitioners, who own 100 percent of the voting stock of a corporation, are required to treat the prorata redemption of nonvoting stock held in proportion to their common stock holding as a dividend rather than as a return of capital.

(2) ***

*** Portions of the Tax Court's findings of fact and opinion, relating to an issue not involved herein, have been omitted; and such omissions are indicated by asterisks.

Appendix A

Some of the facts have been stipulated. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Joseph Miele, petitioner in docket No. 405-70, is an individual residing in West Orange, N. J. Anthony P. Miele and Maria E. Miele, petitioners in docket No. 422-70, are individuals, husband and wife, also residing in West Orange, N. J.

V. James Spiniello and Gloria Spiniello, petitioners in docket No. 421-70, are individuals, husband and wife, residing in Short Hills, N. J. Luke C. Spiniello and Grace Spiniello, petitioners in docket No. 423-70, are individuals, husband and wife, also residing in Short Hills, N. J.

Petitioner Joseph Miele filed individual income tax returns for the taxable years 1965 and 1966 with the district director of internal revenue, Newark, N. J. Petitioners Anthony and Maria Miele, V. James and Gloria Spiniello, and Luke C. and Grace Spiniello filed joint income tax returns with the district director of internal revenue, Newark, N. J. All of the returns were filed on the cash basis.

Maria E. Miele, Gloria Spiniello, and Grace Spiniello are parties to this proceeding solely by virtue of the joint income tax returns which they filed with their respective husbands for the taxable years here involved.

I. *Findings Related to the Preferred Stock Redemption Issue*

A & S Transportation Co. (hereinafter referred to as "A & S") was incorporated under the laws of New Jersey on January 17, 1945. The original authorized capital of

Appendix A

A & S, as provided for in its certificate of incorporation, consisted of 1,000 shares of common stock having a par value of $100 per share.

For some time prior to April 1959, there were 132 issued and outstanding shares of A & S common stock (as described above) which were held as follows:

Joseph Miele	21	Joseph LaFera, Sr.	1
Anthony Miele	21	Joseph LaFera, Jr.	1
Luke Spiniello	21	LaFera Coal & Construction Co., Inc.	42
James Spiniello	22	Virgilio Spiniello (Father of James & Luke)	2
J. Franklyn Ficken	2		

On June 23, 1949, J. Franklyn Ficken sold and assigned his 2 shares of A & S stock to Joseph and Anthony Miele. The said 2 shares were transferred to Richard J. Miele, son of Anthony Miele, on August 26, 1962. Virgilio Spiniello died on January 20, 1962, bequeathing by will his share[2] of A & S stock to Luke Spiniello, who has since held a total of 22 shares.

LaFera Coal and Construction Co. was an equipment rental company owned by Joseph LaFera, Sr. and Joseph LaFera, Jr. On October 1, 1962, LaFera Coal and Construction Co. became a wholly owned subsidiary of La-

[2] The stipulation of facts specifies that only 1 share was bequeathed by Virgilio to Luke although the stipulation also specifies that Virgilio held 2 shares and does not set forth the disposition of the remaining share.

Appendix A

Fera Contracting Co. (hereinafter referred to as "Contracting") in a tax-free reorganization. Thereafter, on September 3, 1963, LaFera Coal and Construction Co. was liquidated in accordance with a plan adopted on August 30, 1963, and Contracting succeeded to all of the assets of LaFera Coal and Construction Co., including the 47 shares of A & S stock which it held.

At all times since its incorporation, A & S has been engaged in the business of moving sludge out to sea by means of one or more seagoing barges. For some time prior to April 1959, A & S carried on its business activities by the operation of a single barge called the "Dykes".

By approximately 1956, the "Dykes" was in such a poor state of repair that maintenance costs were exceeding the value of the vessel. At a meeting of the Board of Directors of A & S held on September 15, 1957, it was noted that key employees of A & S had accepted notes in lieu of salary in order to free funds for the repair of the "Dykes".

The Management of A & S ascertained that a new vessel to replace the "Dykes" would cost approximately $545,000. Since A & S could not afford to make such a purchase without financing from outside sources, it entered into negotiations with the United States Maritime Commission (hereinafter sometimes referred to as the "Maritime Commission" or the "Commission"). This Commission, in furtherance of public policy was empowered by applicable law to guarantee, in proper cases, fully secured first mortgage loans made to domestic shipping companies to finance the purchase of seagoing vessels.

The Maritime Commission advised A & S that at least $150,000 of additional capital from private sources would

have to be invested in the corporation before the loan could be guaranteed. The Maritime Commission also advised A & S that this requirement of additonal private capital could be satisfied in either of the following ways:

(1) An unsecured loan for $150,000 which would be subordinated to the loan to be guaranteed by the Maritime Commission or

(2) The issuance of non-voting, non-dividend paying, non-cumulative preferred stock, having an aggregate par value of $150,000, which could not be redeemed until after full payment of the proposed first mortgage loan.

The principals of A & S, including Anthony and Virgilio Spiniello, preferred the alternative of making an unsecured loan. However, they accepted the opinion of their advisor (one Samuel Klein, an attorney and certified public accountant) that the issuance of preferred stock would accomplish their entire purpose in the shortest time, and on March 30, 1959, by action of its board of directors, the certificate of incorporation of A & S was amended in pertinent part to provide as follows:

> * * * The total authorized capital stock of this corporation is Two Hundred Fifty Thousand ($250,000.00) Dollars, divided into three hundred (300) shares of preferred stock, of a par value of Five Hundred ($500.00) Dollars each, and One Thousand shares of common stock of the par value of One Hundred ($100.00) Dollars each.
>
> The preferred stock shall be non-voting, non-dividend and non-cumulative and shall be redeemed by the corporation in full at par value ten years after April 15, 1959, and may be redeemed by the corporation at par value on or after July 15, 1964.

Appendix A

On April 13, 1959, A & S issued preferred stock to its common shareholders for cash as follows:

Number of Shares	*Issued to*	*Par Value*
50	Joseph Miele	$ 25,000
50	Anthony Miele	25,000
50	Luke C. Spiniello	25,000
50	V. James Spiniello	25,000
100	LaFera Coal and Construction Co.	50,000
300	Total	$150,000

The preferred stock certificates were stipulated to be "non-voting, non-dividend paying, non-cumulative," and were required "to be redeemed no later than 10 years after date of issuance". The preferred stock could also be redeemed prior to the expiration of this 10-year period but only after July 15, 1964, the prospective maturity date of the pending bank loan. A & S represented the certificates as preferred stock to the Maritime Commission, and A & S did not show the amounts received for the preferred stock as a loan in its tax returns.

On July 17, 1959, the board of directors of A & S authorized a bank loan of $380,000 to be secured by a first preferred ship mortgage on the sludge barge "Judson K. Stickle" which was to be purchased as a replacement for the "Dykes". The loan was to be repayable in 60 equal consecutive monthly installments of $5,000 and a final "balloon" payment of $80,000. Interest, payable monthly, was to be at the rate of 5 percent per annum.

Appendix A

The $380,000 bank loan was consummated on July 31, 1959, on essentially the terms set out above. The first preferred ship mortgage, which A & S executed on this same date, had a stated maturity date of August 31, 1964. The mortgage expressly prohibited the payment of any dividend or repayment of an indebtedness to a stockholder "so long as this Mortgage and any installment of the Mortgage Note is outstanding, • • •".

The sludge barge "Judson K. Stickle" was delivered to A & S on July 31, 1959. Thereafter, A & S operated the "Judson K. Stickle" and made the payments due under the mortgage not given by A & S at the closing, the last of such payments being made on or about August 31, 1964.

On May 14, 1965, the board of directors of A & S, at the insistence of the shareholders, resolved to redeem 150 shares of the preferred stock from the holders of record in proportion to their holdings. On or about May 14, 1965, A & S, pursuant to this resolution, acquired one-half of the preferred stock from its shareholders:

Shareholder	*Number of Shares Redeemed*	*Amount Paid by A & S For the Stock*
LaFera Contracting Co., Inc.	50	$25,000
Luke C. Spiniello	25	12,500
V. James Spiniello	25	12,500
Joseph Miele	25	12,500
Anthony P. Miele	25	12,500
Total	150 shares	$75,000

Appendix A

On or about January 2, 1966, the board of directors of A & S, again at the insistence of the shareholders, resolved to redeem the remaining 150 shares of preferred stock. On or about January 2, 1966, A & S, pursuant to this resolution, acquired the remaining one-half of the preferred stock as follows:

Shareholder	*Number of Shares Redeemed*	*Amount Paid by A & S For the Stock*
LaFera Contracting Co., Inc.	50	$25,000
Luke C. Spiniello	25	12,500
V. James Spiniello	25	12,500
Joseph Miele	25	12,500
Anthony P. Miele	25	12,500
Total	150	$75,000

• • •

ULTIMATE FINDINGS OF FACT

1. Preferred Stock Redemption Issue

(a) The preferred stock issued by A & S and later redeemed in accordance with the terms of the stock certificate was preferred stock and not evidence of indebtedness.

(b) The pro rata distributions made by A & S in redemption of its preferred stock were essentially equivalent to a dividend and do not qualify as a distribution or payment in exchange for stock under section 302(a).[3]

• • •

[3] All statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

Appendix A

Opinion

I. *Questions with Respect to the Stock Redemption by A & S Corporation*

A & S engaged in the business of operating a seagoing barge. In 1959, A & S decided to purchase a new barge and entered into negotiations to finance the acquisition. One aspect of the negotiations included obtaining a guarantee by the United States Maritime Commission of a fully secured first mortgage loan. The Maritime Commission advised A & S that at least $150,000 of additional capital from private sources would have to be invested in the corporation before the loan could be guaranteed.

The Maritime Commission posed two alternatives for providing for the additional capital:

(1) An unsecured loan subordinated to the guaranteed note or

(2) An issue of preferred stock.

The board of directors of A & S adopted the alternative of issuing preferred stock as the means of investing the additional capital. The stockholders invested in the newly created preferred stock in proportion to their holdings in the common stock of A & S. As a result of this additional capital, the Maritime Commission guaranteed the first mortgage loan thus enabling A & S to acquire a new barge.

A & S took possession of the new barge on July 31, 1959. Thereafter it operated the barge and amortized the note guaranteed by the Maritime Commission making the final payment on or about August 31, 1964.

Appendix A

On May 14, 1965, the board of directors of A & S, at the insistence of the shareholders, decided to redeem one-half of the outstanding preferred stock in proportion to the ownership thereof. On January 2, 1966, the balance of the preferred stock was redeemed. The redemptions were pro rata, and after each redemption the shareholders occupied exactly the same relationship with respect to the ownership of A & S as they did before the redemption.

Initially, the petitioners contend that the "preferred stock" in this case was evidence of debt and not equity. We cannot accept this argument.

No all encompassing rule has been evolved and accepted for application in all cases to determine whether the obligations in question in a particular case are evidence of equity investment in the corporations involved or are evidence of indebtedness. It is clear that no single characteristic is determinative in all cases and that the basic question of whether the holders of the obligations are stockholders or creditors must be determined by an analysis of all relevant factors. *John Kelly Co.* v. *Commissioner,* 326 U. S. 521 (1943); *Ragland Investment Co.,* 52 T.C. 867 (1969).

The Martime Commission required that $150,000 of additional capital be invested in A & S before the Commission would guarantee the loan for the acquisition of a new barge. The Maritime Commission gave the petitioners the alternatives of either a loan or an issue of preferred stock as the means of providing for this additional capital. Thus, the petitioners were in a position to control the nature of the investment. They chose the preferred stock or equity investment over the debt method of financing, and having made this choice, petitioners can-

not escape from the statutory consequences of their decision by arguing that the transaction could have been arranged in another way with different consequences. *Wiseman* v. *United States*, 371 F. 2d 816 (C. A. 1, 1967); *United States* v. *Collins*, 300 F. 2d 821 (C. A. 1, 1962); *Pacific Southwest R. Co.* v. *Commissioner*, 128 F. 2d 815 (C. A. 9, 1942); *Comimssioner* v. *Kolb*, 100 F. 2d 920 (C. A. 9, 1938); Cf., *Gray* v. *Powell*, 314 U. S. 402, 414 (1941).

In addition, there are numerous other factors which indicate that the certificates in question represent equity and not debt. The certificates were labeled, structured, and repeatedly referred to throughout as preferred stock. While the name given to a security is not necessarily determinative in regards to its nature, the nomenclature used by the parties is a factor which cannot be ignored. *Crawford Drug Stores* v. *United States*, 220 F. 2d 292 (C. A. 10, 1955); *John Wanamaker Philadelphia* v. *Commissioner*, 139 F. 2d 644 (C. A. 3, 1943); *First Mortgage Corp.* v. *Commissioner*, 135 F. 2d 121 (C. A. 3, 1943).

The attorney-adviser for A & S, Samuel Klein, readily admitted to the Court that if the corporation went into receivership, the holders of the certificates here in question could not file claims as creditors.[4] Since it is a

[4] Under New Jersey law, it is apparent that the certificates in question would be classified as preferred stock. See *Hilson Co.* v. *State Board of Assessors*, 82 N. J. L. 2, 80 Atl. 929 (Sup. Ct. N. J. 1911). As preferred stock, the redemption preference established by the certificates could only be enforced when it would not render A & S insolvent. *Mueller* v. *Kraeuter & Co.*, 131 N. J. Eq. 475, 25 A. 2d 874 (Ct. Ch. N. J. 1942). Thus, the certificates did not establish debt but only created a preference for the holders of the certificates over the rights of the common stockholders.

normal characteristic of a creditor relationship that the creditors share in the assets of a corporation before the stockholders (the preferred stockholders sharing in the assets before any other class of stock) or any other group in the event of a liquidation or dissolution of the corporation, the rights of the holders of the certificates in question herein are in essence subordinated to the rights of the general creditors of the A & S corporation. This factor of subordination is generally regarded as indicative of an equity as opposed to a creditor interest. *Milwaukee & Suburban Transport Corporation* v. *Commissioner*, 283 F. 2d 279 (C. A. 7, 1960); certiorari denied 366 U. S. 965 (1961), remanded on another issue 367 U. S. 906 (1961); *John Wanamaker Philadelphia* v. *Commissioner, supra; First Mortgage Corp.* v. *Commissioner, supra.*

If a creditor-debtor relationship had been intended, it would have only been necessary for the board of directors of A & S to authorize the execution of bonds or notes. It would not have been necessary for the board to amend the certificate of incorporation of A & S to provide for an increase in the amount of authorized capital stock. The fact that the board of directors of A & S took this latter action tends to indicate that the board intended to create additional capital stock or equity. *John Wanamaker Philadelphia* v. *Commissioner, supra.*

The certificates in question did not provide for the payment of any interest, and we consider this absence of an interest element as indicating that the purported debt was in reality a capital contribution. *Road Materials, Inc.* v. *Commissioner*, 407 F. 2d 1121 (C. A. 4, 1969); *Curry* v. *United States*, 396 F. 2d 630 (C. A. 5, 1968), certiorari denied 393 U. S. 967 (1968); *Alfred R. Bachrach*, 18 T. C. 479 (1952), affd. 205 F. 2d 151 (C. A. 2, 1953).

Furthermore, the purported debt in this case was held by the petitioners in proportion to their respective stockholdings. While such proportionality by itself is not sufficient to establish the purported debt is in fact equity. *Piedmont Corporation* v. *Commissioner,* 388 F. 2d 886, 889 (C. A. 4, 1968), and *Liflans Corporation* v. *United States,* 390 F. 2d 965, 971 (Ct. Cl. 1968), it is a factor which is indicative of an equity interest as opposed to a debt interest. *Charter Wire, Inc.* v. *United States,* 309 F. 2d 878 (C. A. 7, 1962); *P. M. Finance Corporation* v. *Commissioner,* 302 F. 2d 786 (C. A. 2, 1957).

When A & S sought to demonstrate to the United States Maritime Commission that it had provided for the increase in the equity interest in the corporation which the Commission had requested, the certificates in question were represented to the Commission as preferred stock. Such a representation is indicative of an intention to create equity and not debt. *Milwaukee & Suburban Transport Corporation* v. *Commissioner, supra.* See also *Lee Telephone Co.* v. *Commissioner,* 260 F. 2d 114 (C. A. 4, 1958).

In addition, A & S did not show the amounts it received for the issuance of its preferred stock as a loan on its tax return. We consider such corporate treatment of the amounts involved as evidence of the fact that the certificates were equity and not debt. Cf. *First Mortgage Corp.* v. *Commissioner, supra* at 123, 124 (where the failure of the corporation to follow the usual procedures associated with debt was considered as evidence that debt was not intended), and *Byerlite Corporation* v. *Williams,* 286 F. 2d 285, 290 (C. A. 6, 1960) (where the corporate treatment of amounts received was regarded as evidence of whether or not there was an intention to create a debt).

Appendix A

The existence of a definite maturity date is a significant factor indicating the existence of a debtor-creditor relationship. *Wood Preserving Corporation of Baltimore* v. *United States,* 347 F. 2d 117, 119 (C. A. 4, 1965); *Parisian, Inc.* v. *Commissioner,* 131 F. 2d 394 (C. A. 5, 1942); *Commissioner* v. *Schmoll Fils Associated,* 110 F. 2d 611, 613 (C. A. 2, 1940); see also section 385(b)(1), I.R.C. 1954, added by section 415(a) of the Tax Reform Act of 1969. While the certificates in question do have such a definite maturity date in that they must be redeemed at the end of a specified period of time, we do not consider this as conclusive of the character of the certificates, *Consumers Credit Rural Electric Coop. Corp.* v. *Commissioner,* 319 F. 2d 475 (C. A. 6, 1963); *Crown Iron Works Co.* v. *Commissioner,* 245 F. 2d 357 (C. A. 8, 1957); *Kentucky River Coal Corporation,* 3 B. T. A. 644 (1926), as it is not unusual for preferred stock to have a maturity date. *Charles L. Huisking & Co.,* 4 T. C. 595, 599 (1945). Rather, we have weighed this factor with all other factors present in this case, and we hold that the indicia of equity predominate with certainty. Accordingly, we have concluded that the certificates in question were in fact preferred stock as opposed to evidence of indebtedness.

Having disposed of petitioner's initial contention, we must now consider their second argument. The petitioners stress that the preferred stock was issued because the Maritime Commission required them to invest an additional $150,000 of capital in the corporation as a condition precedent to its guaranteeing of the loans which were necessary to enable A & S to finance the acquisition of a new barge. They argue that the preferred stock was no longer needed after the loan had been paid in full and that redemption of the stock was consistent with the business purpose for which the stock was issued. On this

basis, they conclude that the redemption transaction was within the protection of section 302(b)(1).

We consider this argument as having been foreclosed and the issue determined by the case of *United States* v. *Davis*, 397 U. S. 301 (1970). In *Davis*, the United States Supreme Court held that a redemption without a change in the relative economic interests or rights of the stockholders is always essentially equivalent to a dividend under section 302(b)(1). It is the effect of the redemption and not the purpose behind it which is determinative of dividend equivalence. See also *Hasbrook* v. *United States*, 343 F. 2d 811 (C. A. 2, 1965); *Kessner* v. *Commissioner*, 248 F. 2d 943 (C. A. 3, 1957); and *Ray A. Maher*, 55 T. C. 441 (1970). Hence, we hold that in this case, where the redemption of the preferred stock of A & S in two equal installments did not change the relative economic interests, control, or rights of the stockholders (the petitioners herein), the redemption was essentially equivalent to a dividend and does not qualify as a distribution or payment in exchange for the stock.

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Decisions will be entered for the respondent in docket Nos. 405-70 and 422-70.

Decisions will be entered under Rule 50 in docket Nos. 421-70 and 423-70.

APPENDIX B

T. C. Memo. 1971-161

UNITED STATES TAX COURT

LAFERA CONTRACTING COMPANY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 424-70

Filed July 12, 1971

[Appearances of counsel omitted]

MEMORANDUM FINDINGS OF FACT AND OPINION

QUEALY, *Judge:* The respondent determined a deficiency in petitioner's income tax for the taxable year ended September 30, 1964 in the amount of $5,214.02.

Other issues having been previously disposed of, the parties filed a stipulation at trial in which the petitioner conceded the respondent's disallowance of the petitioner's claimed salary deductions.

Appendix B

This stipulation of the parties also sets forth their agreement concerning the disposition of a preferred stock redemption issue. They agreed that with respect to this issue, they would be bound by the ultimate judicial determination in the consolidated trial of *Joseph Miele, et al.*, 56 T. C. No. 45. (Docket Nos. 405-70, 421-70, 422-70, 423-70). In the *Miele* case, we found and held that the preferred stock redemptions were essentially equivalent to a dividend and did not qualify as a distribution or payment in exchange for stock under section 302(a). Therefore in accordance with the stipulation of the parties, we hold the preferred stock redemptions in question in the instant case were essentially equivalent to a dividend and do not qualify for section 302(a) treatment.

Decision will be entered under Rule 50.

APPENDIX C

Judgment Order

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 72-1031 and 72-1032

JOSEPH MIELE,

Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

(Tax Court Docket No. 405-70)

ANTHONY P. MIELE and MARIA E. MIELE,

Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

(Tax Court Docket No. 422-70)

Submitted Under Third Circuit Rule 12(6)
January 29, 1973

Appendix C

Before SEITZ, *Chief Judge,* ALDISERT, *Circuit Judge.*

After reviewing appellants' contentions, and finding the case controlled by the decision of the United States Supreme Court in *United States* v. *Davis,* 397 U. S. 301 (1970), it is

ORDERED AND ADJUDGED that the judgment of the Tax Court of the United States is affirmed.

Costs taxed against appellants.

By the Court,

COLLINS J. SEITZ
Chief Judge

Attest:

THOMAS F. QUINN
Clerk

Dated: January 30, 1973

Appendix C

IN THE
UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 72-1254, 72-1255 and 72-1368

V. JAMES SPINIELLO and GLORIA SPINIELLO,
Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

(Tax Court Docket No. 421-70)

LUKE C. SPINIELLO and GRACE SPINIELLO,
Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

(Tax Court Docket No. 423-70)

Appendix C

LaFera Contracting Company,

Appellant,

v.

Commissioner of Internal Revenue,

Appellee.

(Tax Court Docket No. 424-70)

Present: Seitz, *Chief Judge,* and Aldisert, *Circuit Judge.*

Judgment Order

A joint stipulation of the parties in the above-entitled cases was granted by the Clerk on May 18, 1972, providing that the determination of this Court with respect to the issues presented in Docket Nos. 72-1031 and 72-1032 (*Joseph Miele, et al.* v. *Commissioner*) shall be dispositive of appellants' respective appeals herein. In accordance with that stipulation and with the Judgment Order entered January 30, 1973, in Nos. 72-1031 and 72-1032, it is Ordered and Adjudged that the decisions of the United States Tax Court in the above-captioned cases are affirmed.

By the Court,

Collins J. Seitz
Chief Judge

Dated: April 11, 1973

Attest:

Thomas F. Quinn
Clerk

APPENDIX D

Order of the United States Tax Court

UNITED STATES TAX COURT
WASHINGTON

Docket No. 405-70

JOSEPH MIELE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ORDER

Upon consideration of counsel for petitioner's motion to substitute parties and change caption filed April 25, 1973, in which it is represented that respondent has no objection, it is

ORDERED that the motion is granted and the caption of this case is amended to read "Estate of Joseph Miele, Deceased, Norman E. Albers, Nicholas Joya and Horace D. Marucci, Executors, petitioners, v. Commissioner of Internal Revenue, respondent".

(Signed) W. M. DRENNEN
Judge

Dated: Washington, D. C.
May 8, 1973